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Short-Term Prospects in the International Money Market

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Short-Term Prospects in the International Money Market

The dollar has been relatively strong in international financial markets in recent weeks, and the Europeans have had little difficulty in maintaining their joint float. Nevertheless, the existence of a fixed European currency band is an inviting target for corporate and financial money managers and speculators.

- Underlying balance-of-payments trends should result in upward pressure on the mark and French franc in the short-term and downward pressure on the Scandinavian currencies.
- Any unsettling economic or political news from a band country is a potential source of speculative pressure.
- Among non-band currencies, the yen will be under moderate upward pressure in the short term and the Swiss franc and pound sterling under downward pressure.
- Any substantial change from the present exchange rate by any of these currencies will have a destabilizing impact on the European band.

On balance, it seems that a successful attack on the European band is inevitable, probably before autumn. The scenario could strongly resemble that of the attack on sterling in June 1972.

- Money managers will focus on what they perceive as the weakest currency in the band, selling that currency in exchange for the strongest band currency.
- The nation whose currency is under attack will be forced out of the band after attempting to deflect speculation through central bank support operations.

Note: Comments and queries on this publication are welcomed. They may be directed

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DISCUSSION

The Currency Crises

1. The 12 February dollar devaluation failed to restore money market stability. Coming only 14 months after the Smithsonian realignment and only seven months after the sterling crisis, it further eroded market confidence in the existing system of fixed exchange rates. The repeated crises demonstrated the ease with which vast quantities of money could be quickly shifted among major currencies despite strengthened capital controls. They also showed that the major central banks were either unable or unwilling to defend fixed exchange rates by absorbing and neutralizing these flows.

2. Continuing speculative pressures forced the central banks to intervene to support the new exchange rate pattern during the week of 26 February - 2 March (see Table 1). On Thursday, 1 March, the heaviest intervention in history was required, predominantly in West Germany, forcing a closing of most official foreign exchange markets. Paris opened its exchange market on 2 March – for political reasons – apparently

Table 1

Central Bank Intervention
12 February - 2 March 1973

Million US $

	12-16 Feb	19-22 Feb	23 Feb	26-27 Feb	28 Feb	1 Mar	2 Mar	Total
Total	+310	-968	+610	....	+164	+3,567	+400	+4,083
Belgium	....	....	+12	....	...	+180	....	+192
France	....	....	+36	....	....	+130	+400	+566
Japan	+310	....	....	....	-7	-18	....	+285
Netherlands	....	....	+25	....	+151	+604	....	+780
Switzerland	....	....	+530[1]	....	....	....	....	+530
United Kingdom	....	-25	....	....	+20	+15	....	+10
West Germany	....	-943	+7	....	....	+2,656	....	+1,720

1. For 21-23 February. An additional $150 million was purchased in the forward market.

confident that its controls would insulate the franc from speculative pressures, but it was forced to close within hours after extensive dollar support was required.

3. Drawings by multinational firms and commercial banks on the Eurodollar market accounted for the bulk of $12 billion (net) converted during the recent crises. US commercial banks, according to a Federal Reserve study, experienced a net outflow of $2.5 billion between 3 January and mid-March, largely because of foreign bank drawdowns on existing credit lines. In addition, foreign bank agencies and branches in the United States report an outflow of $1.2 billion in February, both for their own and customer accounts. Most of the remaining $8 billion converted is accounted for by Eurodollar drawings, primarily by foreign banks, particularly Swiss and to a lesser extent British and German, and by US and foreign multinationals. Middle East private and official dollar conversions, primarily by Kuwait and Libya, through the Eurodollar market, totaled less than $1.5 billion in the January-March period.

4. It was generally recognized after the 26 February - 2 March run on the dollar that another currency realignment followed by a return to fixed exchange rates would not restore exchange stability. Many Europeans, however, felt that if the Common Agricultural Policy was to continue effectively, if intracommunity trade was to be undisturbed, and if the competitive position of each of the European countries was to be protected, some fixed relationship had to be maintained among the major EC currencies. Even so, the EC countries could not reach agreement until mid-March. Finally, at the EC finance ministers' meeting in Brussels on 11 March the EC did announce agreement on a joint float, excluding the pound and the lira. The plan was presented at the enlarged G-10 meeting in Paris on 16 March and went into effect on 19 March with the five EC currencies and the Norwegian and Swedish crowns participating.

Floating Currencies

5. All of the major world currencies are now floating relative to the dollar. The German mark, Dutch guilder, French and Belgian francs, and Swedish, Danish, and Norwegian crowns are floating as a unit. The Canadian dollar has been floating since May 1970, the British pound since June 1972, and the Swiss franc since January 1973. As part of the 12 February currency settlement the yen and the Italian commercial lira were also floated. (The financial lira has been floating since Rome introduced a two-tier exchange market system in January.)

6. A French-German compromise paved the way for the joint EC float. Bonn, concerned that a unilateral float would erode Germany's

competitive position within the Community, was the joint float's principal advocate. The French agreed in principle, but Paris continued to insist on UK participation in the belief that sterling's weakness would prevent any significant appreciation of the floating currencies and thereby protect Europe's competitiveness vis-a-vis the United States. The United Kingdom, however, insisted on a guaranty of unconditional interest-free support of the pound by the stronger EC countries if a speculative run on sterling ensued. Bonn balked at this demand, which could have resulted in German assumption of Britain's massive overseas liabilities. To win French approval of the joint float, however, the Germans did agree to appreciate the mark by 3%, thereby weakening it somewhat in the eyes of money market managers and reducing potential upward pressure on the jointly floating currencies.

7. The participants in the joint float have agreed to keep their currencies within a 2.25% band which is free to fluctuate relative to the dollar. The mechanics for maintaining the band are similar to those used to maintain the EC Snake in the Tunnel, which is no longer operative. The countries with the strongest and weakest currencies in the band enter the market to stay within the band. The country (or countries) whose currency is at the floor sells the strongest currency (which may have been acquired by drawing on interbank swap lines) in exchange for its own currency; the strong currency country uses its currency to purchase the weak currency. Central banks are believed to have the discretion, as a protective measure, to intervene before their currencies reach the limits – a policy not allowed under the previous intervention arrangement. The central banks will also intervene, if necessary, to prevent too rapid an appreciation of their currencies against the dollar.

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Market Developments

9. The dollar was firm in moderate trading after official foreign exchange markets reopened on 19 March (see Table 2). Even disappointing

Table 2

Currency Movements from Smithsonian Rates
16, 23, 30 March, 6 April, and 13 April 1973

	Smithsonian Rate (Units per US Dollar)	Percent Change				
		16 Mar	23 Mar	30 Mar	6 Apr	13 Apr
Currencies in European float						
Belgian franc	44.82	+13.83	+13.06	+12.08	+11.97	+11.89
Danish crown	6.98	+13.68	+13.04	+12.50	+12.41	+12.52
French franc	5.12	+13.68	+12.59	+12.80	+12.61	+12.59
German mark	3.22	+14.86	+13.97	+13.58	+13.50	+13.79
Netherlands guilder	3.24	+12.76	+11.89	+10.27	+10.49	+10.30
Norwegian crown	6.65	+12.63	+12.57	+12.59	+12.47	+12.73
Swedish crown	4.81	+9.14	+7.49	+7.10	+7.01	+6.83
Major independently floating currencies						
Italian lira	581.5	+1.57	+1.17	+0.52	-1.11	-0.92
Japanese yen	308	+19.38	+16.23	+15.82	+16.05	+15.88
Swiss franc	3.84	+18.79	+18.24	+18.57	+18.57	+18.82
United Kingdom pound	0.384	-5.36	-5.02	-4.91	-4.73	-4.73

US trade news for February and reports of a rising German trade surplus had little adverse impact on the dollar's value. Japan had to sell dollars to keep the dollar's value from rising too fast. In the face of increased dollar demand to meet an import payments backlog and special payments to the United States for nuclear services and equipment, Tokyo sold some $875 million from 19 March to 13 April. Japanese official dollar purchases between January and March totaled about $1.4 billion. Official German reserve data for recent weeks indicate that the Bundesbank also has been selling dollars. The dollar continues to trade at a substantial forward discount relative to most major currencies.

10. The mark and more recently the guilder have become the weakest currencies in the European band. As of 17 April, the mark, weakened by its additional 3% revaluation, was down about 0.5% from its new central rate and was near the bottom of the new European band. The Bundesbank

sold several hundred million dollars in French francs and a much smaller amount of Belgian francs and Swedish and Danish crowns to keep the mark within the band. The French and Belgian francs and the Scandinavian currencies have generally been strong, the French currency recovering with the Gaullist election victory.

11. Sterling, the lira, and the Swiss franc, the three principal European currencies floating independently, have behaved dissimilarly. The pound, helped by tight money conditions in England, has strengthened somewhat. In Italy, the central bank reported continuing adverse leads and lags and has intervened moderately to slow the lira's decline. The Swiss franc, which at one time had appreciated by 25% relative to its old central dollar rate, weakened somewhat before the official currency markets reopened, but it still shows the greatest appreciation of any European currency.

12. The generally light currency trading so far indicates that most traders are taking a wait-and-see attitude. Many who bought marks and other currencies will hold off their dollar repurchases until they have a clearer picture of payments trends. The free market gold price has fluctuated widely in light trading. A sharp rise in the price to $90 an ounce in late March reflects, in part, a shift by speculators, including Middle Eastern interests, out of currencies into gold.

Prospects for the Joint Float

13. Independently floating currencies are less subject to attack than currencies with fixed exchange rates. Money market managers face the risk that the direction of currency movement will be sharply reversed as a consequence of new market developments. The adverse consequences of this are reduced, of course, if the float is coordinated with the currency floats of other countries which account for a large proportion of the country's trade, or with which special programs requiring relatively fixed exchange rates are maintained, as in the case of the EC. The reduction in risk associated with a float through coordination imposes a cost, however, inasmuch as the coordination or tying of the floating currencies will facilitate speculation.

14. The mere existence of a currency band serves as an enticement to money market managers. At the first sign of relative weakness in a band currency, they will sell that currency in exchange for the strong currency in the band. The potential rewards from trading are substantially larger than they would be in the absence of the band, as the managers stand to gain both from the weak currency's dropping out of the band and subsequent depreciation, and from the appreciation of other band currencies. In the June 1972 pound crisis, for example, the pound, once

freed from the EC Snake, depreciated 3.7% relative to the dollar during 23-28 June, while the French and Belgian francs, now freed from the depressing influence of the pound, appreciated 1.3% relative to the dollar. Speculators consequently stood to gain 5.0% rather than 3.7%.

15. One of the major requirements facing the joint float participants is the establishment of an adequate reserve pool to defend the band. The EC Monetary Fund began operation in April but it is not clear what influence the Fund will have on the joint float. Its initial role will be that of a clearinghouse – i.e., a mechanism for the multilateral settlement of claims resulting from central bank interventions in Community currencies. It also will administer very short-term financing of member support operations. In any event its present resources – $1.8 billion – are inadequate to assume central bank functions and maintain the band if large-scale speculation resumes.

16. More than enough liquid funds are now available in the money market to force a currency out of the European band. The Eurocurrency potentially available for speculation in the short term probably totals about $20 billion. No country participating in the joint float would be willing to absorb even a quarter of this amount in an effort to defend the band. Outside of West Germany and possibly France it seems unlikely that any country would be willing to intervene and purchase even as much as $1 billion. The Scandinavian countries (Sweden in particular) will be especially reluctant, because of domestic political opposition and the relative importance of their trade with countries floating independently, to intervene to defend the band.

17. Unless some provision is made to control the massive funds available for speculation, a successful attack on the joint float is inevitable. The operation of the EC Snake demonstrated that a currency band can be maintained only in a calm market. In June 1972 a speculative attack against sterling forced London to float its currency independently, although the pound at the time was not believed to be substantially overvalued. Denmark and Ireland also dropped out of the band arrangements as a consequence of that crisis. Despite a major modification in the agreement designed to prevent Italy from withdrawing, Rome independently floated the lira as part of the 12 February currency settlement. (Italy had gone to a two-tier system in January with a floating financial lira after an extended period of capital outflow.) Of the original nine participants in the EC Snake, only France, West Germany, and the Benelux countries have consistently maintained their membership within the band.

18. New capital controls have been added in France, Sweden, and the Benelux countries to discourage further speculative inflows. The French

controls prohibit commercial banks from increasing their net foreign liabilities and from debiting non-resident accounts for the purchase of French securities. A 100% reserve requirement on new foreign deposits was also imposed retroactive to 4 January. Commercial banks in France and the Benelux countries, following the example of banks in West Germany and Switzerland, have imposed negative interest charges on non-resident accounts to cover the costs associated with maintaining a high reserve ratio.

19. The new controls are likely to prove as ineffective in shutting off speculative flows as the impressive number of capital controls that were already operating in Europe, although they may further inhibit legitimate private investment. In the absence of restraints on capital outflows or Eurocurrency creation, the burden of capital control falls on the strong currency country. As long as leads and lags remain to be exploited or these countries permit foreign currency conversion into any domestic asset or as long as loopholes exist in the administration of the controls by the commercial banks, currency movements can occur, although controls will make it somewhat more expensive.

20. An unexpected event – political or economic – within a band country would provide a target currency for speculators. The relative stability in exchange markets to date reflects partly the fact that money market managers have not identified a clearly weaker or stronger currency within the band. The joint float without Italy and the United Kingdom is clearly more viable than a float that would have included these more uncertain currencies. All of the present participants in the joint float have currencies that are generally thought to be strong, and no market consensus has yet developed over which is relatively stronger.

Short-Term Prospects for Individual Currencies*

21. The short term – the next 3-6 months – will see a reversal of some current trends. Balance-of-payments projections for the major industrial countries indicate that the mark will in the short term again become a strong currency. The yen and French franc will continue to be strong. These projections also indicate that the lira will stabilize and the Canadian dollar will remain stable but that sterling, the Swiss franc, and the Scandinavian currencies will weaken somewhat. Market behavior, of course, will also be affected by central bank interest rate and intervention activity and by money market assessment of currency potential, which is often based on psychological and/or political factors rather than balance-of-payments analyses.

* For additional details, by country, see the Appendix.

22. West Germany and Japan probably will experience trade surpluses on the order of $2 billion in the second quarter of 1973. There is already a heavy backlog of foreign orders for German industrial products. Together with the terms of trade improvement resulting from the mark revaluations, the export upsurge should produce a second-quarter trade surplus almost double that reported in the second quarter of 1972. Other items in the German balance of payments will offset only a portion of the trade surplus. Seasonal factors and strong import growth will keep the Japanese trade surplus near $1.6 billion in the second quarter, or slightly less than in the second quarter of 1972. Moreover, the continuing large deficit on services and large net capital outflows will enable Tokyo to show a small basic balance deficit for the quarter and for the first half-year as a whole.

23. Other major industrial nations will exhibit diverse payments patterns in the second quarter. British success in slowing the wage spiral is improving the investment outlook and reducing net capital outflows. Nevertheless, this will merely prevent a trade deficit of record proportions from producing a record basic balance deficit. A probable record French trade surplus will be offset by growing invisible outflows. Italy and Switzerland will show strong basic balance surpluses, but the current high level of the Swiss franc will probably lead to increasing trade deficits and payments pressure later in 1973. The Swedish and Danish trade accounts will also weaken as 1973 wears on.

APPENDIX

SHORT-TERM PROSPECTS FOR INDIVIDUAL CURRENCIES

Japan

There will be little upward pressure on the yen during the next three months, but strong upward pressure will develop if the yen is allowed to float beyond the summer and into the fall. The import payments backlog that developed in February and March has been met, but the demand for dollars will remain strong because of especially rapid import growth and continued large net long-term capital outflows. The only source of possible exchange market pressure is the short-term capital account. Tokyo is in a relatively strong position to control capital inflows, but even in Japan's case speculators have managed to move capital in when they felt the time was right.

A large trade surplus, about $1.6 billion, is likely in the second quarter, despite seasonal influences that normally keep the quarterly trade surplus well below the yearly average. Exports in April-June will increase sharply, primarily because of the terms of trade effect of the two yen revaluations. Imports are also expected to continue their rapid expansion because of the economic boom now in progress. Import licences during the first quarter of 1973 were up by 67% over the first quarter of 1972.

Continued large net service payments will partly offset the trade surplus. The services deficit totaled $600 million in the second quarter of 1972, but some decline from this level is likely because of Japan's increased earnings on foreign investments, including reserve assets. Moreover, as a result of the latest currency change, the Japanese will earn substantially more from local US military spending. The net service deficit in April-June will consequently probably decline to about $400 million, resulting in a current account surplus of about $1.2 billion.

Long-term capital outflows are increasing substantially and will probably offset the current account surplus in the second quarter. Although Japanese investors may delay purchasing foreign assets in anticipation of a further yen appreciation, continued large long-term capital outflows – encouraged by Tokyo – are likely. Outflows will probably average $500 million a month in the second quarter, given existing loan commitments. This would result in a basic balance deficit of about $300 million. Net long-term capital outflows probably exceeded $2 billion in the first quarter this year.

While strong upward pressure on the yen is not expected in the near term, the Bank of Japan is prepared to intervene in the market, if necessary, to prevent any sharp yen appreciation. Tokyo can also hold down the yen through other devices, including slowdowns in the processing of export licenses. This procedure was used in late February and could be reinstituted if necessary. The Ministry of Finance will closely watch the performance of other floating currencies in assessing how high the yen will be allowed to appreciate. While the yen float will not be directly pegged to the joint EC float, Tokyo will attempt to avoid criticism of its own policies by ensuring that a sufficient margin is maintained between the yen and the European currencies.

West Germany

Pressures for a further mark appreciation will probably develop by summer. The large speculative mark holdings resulting from the previous currency crises have kept the mark at or near the bottom of the European currency band in recent weeks. A growing German trade surplus, however, will result in renewed money market interest in the mark even if, as seems likely, the basic balance is only in rough equilibrium. The Bundesbank probably will intervene to prevent too rapid a near-term appreciation, but it will not stand in the way of a moderate upward float.

A trade surplus on the order of $2 billion is expected in the second quarter of 1973, compared with a $1.2 billion surplus in the second quarter of 1972. The export decline in early 1973 was much less than normal. With economic growth and inflationary pressures continuing to accelerate in most of Bonn's major trading partners, the flow of foreign orders to West German industry has increased rapidly. Moreover, there will be a near-term improvement in the terms of trade resulting from the revaluations.

The current account surplus will probably total only about $150 million in the second quarter despite the large trade surplus. The invisibles deficit ordinarily increases as the year proceeds. Foreign workers' remittances grow after the winter months, reflecting the pickup in the construction industry, where many of them are employed. West German's deficit on tourist account does not become significant until the summer months.

The long-term capital account, nearly $4 billion in surplus in 1972, should revert to a small deficit position. The stringent capital controls introduced last year will continue to reduce the inflow of foreign funds, especially portfolio investments, which accounted for more than two-thirds of the 1972 surplus on long-term capital account. Indeed, there was a net long-term outflow of $245 million in October 1972 - January 1973.

Moreover, rising production costs and shrinking profit margins in the domestic economy will increase the attractiveness of foreign investment for Germans, especially now that the revaluations have reduced the mark cost of such investments.

France

The French franc should remain strong in the near term. Underlying its strength are continuing large surpluses on trade and current accounts which will be enhanced by seasonal factors in the second quarter. The basic balance will also be in surplus in the second quarter, but probably will be in equilibrium for the year as a whole. With the elections over, new capital controls in force, and the French interest rates at relatively high levels, the net inflow of short-term funds will probably resume, although the inflow will be much smaller than the $660 million inflow in the second quarter of 1972.

The basic balance surplus in the second quarter of 1973 should total about $300 million, or about the same as in the second quarter of last year. The trade surplus will likely pass the $500 million mark. Although French economic growth will result in a rapid rise in imports, exports are also growing rapidly as French prices remain competitive in world markets.

Increases in workers' remittances abroad and official aid disbursements will probably increase the deficit on services and transfers somewhat. The current account surplus for the quarter will consequently total about $450 million. Long-term capital outflows probably will be about equal to last year's second-quarter outflow of about $150 million.

Italy

The commercial lira is expected to stabilize in the coming month. Seasonal factors will strengthen the lira somewhat, but any significant appreciation is unlikely, given the negative psychology persisting in the market Italy will register its usual large current account and basic balance surpluses in the second quarter of 1973. Nevertheless, exporters and importers fear a further depreciation of the commercial lira. The financial lira market will remain thin and subject to rather volatile movements.

The Bank of Italy is prepared to intervene in the lira market on either side to maintain the lira at close to its current rate if market pressures develop. The Italian economy is still sluggish after a two-year recession and three years of tremendous cost pressures, and the authorities hope that the global devaluation of the commercial lira will bolster export growth and stimulate the economy. At the same time, because of pronounced

criticism at home, the authorities are unlikely to permit the lira to devalue much beyond its old Smithsonian central rate.

A trade surplus of about $100 million is expected in the second quarter, compared with a $200 million surplus in the second quarter of 1972. Exports normally accelerate following the post-holiday lull in the first quarter of the year, while imports expand at a more even pace. Imports, however, will probably increase somewhat more rapidly than usual this year because of the pickup in the Italian economy and the adverse terms of trade effect of the lira's downward float.

Continued large net service and transfer receipts will augment the trade surplus, resulting in a current account surplus of about $600 million in the second quarter of 1973. During 1972, service and transfer receipts totaled about $500 million in the second quarter, and they should be about the same in the second quarter this year.

The long-term capital account will probably be in rough balance through most of the year, while short-term capital outflows will decline. Long-term outflows increased last year but they probably fell off somewhat in early 1973. Should they unexpectedly pick up, the Bank of Italy would encourage state agencies and private interests to borrow abroad, as it has in similar situations in the past. With numerous capital controls, the dual market, and the lira floats, short-term capital outflows should abate somewhat. Nevertheless if speculators feel the time is right, they could manage to move considerable capital out of Italy.

United Kingdom

Sterling will experience some downward presure over the next several months. The basic balance deficit in the second quarter will total about $400 million, or about the same as in the second quarter last year. London will continue to allow the pound to depreciate in response to the market pressure, thereby improving Britain's long-run competitiveness.

A trade deficit of record proportions -- about $600 million -- is expected in the second quarter of 1973. Based on past experience, sterling's depreciation will not significantly help the British trade account until late in 1973. Meanwhile, the adverse terms of trade effects will act to increase the value of imports, while a more buoyant domestic economy will also boost imports and inhibit export growth.

The traditional surplus on services and transfer payments will partly offset the large trade deficit. These items will probably yield a quarterly surplus of about $450 million. The overall current account deficit in the

second quarter of 1973 will consequently total about $150 million. The timelag between a currency realignment and its impact on invisibles is shorter than the lag on trade account. As a result, the invisibles surplus will begin to increase toward the end of the second quarter.

The British deficit on long-term capital is expected to decrease somewhat. A record deficit of over $1.0 billion in the second half of 1972 was associated with the uncertainty surrounding sterling. Now that the market has become more stable, long-term capital movements should return to more normal levels. Moreover, the Heath government's success in slowing wage inflation will increase investment incentives and thereby improve the outlook for the long-term capital balance.

Switzerland

The Swiss franc will experience some downward pressure as 1973 wears on. The recent franc appreciation will increase Switzerland's export income during the next several months as existing orders are filled, but export growth will probably slow later in the year. The export slowdown will have an adverse impact on the domestic economy as a whole. Imports, however, will continue to grow and Switzerland's large deficit will widen.

The growth in the trade deficit will not be matched by an increase in service receipts, although the tourist receipts and investment earnings accounts will remain strong. Switzerland will consequently run a current account deficit for the first time in many years. The Swiss tourist industry, a major foreign exchange earner, should not be significantly affected by the parity change, as Switzerland already caters to a tourist consumer accustomed to high prices. In 1972, tourist receipts -- although adversely affected by Switzerland's mild and relatively snowless winter -- and increased investment earnings helped offset a record trade deficit. The current account consequently showed a small surplus -- about $90 million.

Bern is unlikely to associate itself soon with the joint European float. It fears that it would have to support the weaker European currencies and that use of the Swiss franc as a reserve currency would increase. Moreover, a politically influential body of opinion objects to any further diminution of Swiss neutrality and independence.

Canada

Market forces are likely to keep the Canadian dollar near parity with the US dollar in the near term. The Canadian basic balance in the second quarter of 1973 will decline somewhat from the $540 million surplus in the second quarter of 1972, but the surplus will still be substantial. The

decline will occur mainly in Canada's balances with Japan and Western Europe. The bilateral basic balance with the United States will be little changed. The current account deficit will increase, as interest and dividend remittances are rising, but long-term capital inflows will also grow. The small decline in Canada's basic balance surplus together with continued short-term capital outflows will permit Ottawa to operate a clean float without any significant Canadian dollar appreciation.